FOR ARGUMENT

IN THE

Supreme Court of the United States

OCTOBER TERM 1976

No. 75-1753

SANTA FE INDUSTRIES, INC., SANTA FE NATURAL RESOURCES, INC. and KIRBY LUMBER CORPORATION,

Petitioners,

against

S. WILLIAM GREEN, *et al.*,

Respondents.

BRIEF ON BEHALF OF RESPONDENTS

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Constitutional Provisions, Statutes and Regulations

In addition to the statutes and regulations set forth in the Appendix to the Petitioners' Brief ("PBr"), particularly Section 10(b) of the Securities Exchange Act of 1934 ("1934 Act") and Rule 10b-5 thereunder, involved herein are Article VI, clause 2 of the U.S. Constitution (the supremacy clause) and Section 17(a) of the Securities Act of 1933 ("1933 Act").

Article VI cl. 2, of the U.S. Constitution, insofar as pertinent, reads as follows:

> Clause 2. Supreme Law of Land
>
> This Constitution, and the Laws of the United States which shall be made in Pursuance thereof . . . shall

be the supreme Law of the Land; . . . any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

Section 17(a) of the 1933 Act reads as follows (15 U.S.C. § 77q):

§ 77q. Fraudulent interstate transactions

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

The Question Presented

A fiduciary, owning 95% of its subsidiary's stock, with knowledge from appraisals it had made that such stock was worth at least $772 per share, deliberately undervalued it and unilaterally fixed the price at $150 per share in a secret forced purchase from the 5% minority; the device it used for the purpose was a short form merger with a paper corporation, thereby intentionally misappropriating $15,000,000 from its cestui shareholders: is

that deception, manipulation or fraud within Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder?*

Statement of the Case

This is a derivative action in behalf of Kirby Lumber Corporation, a Delaware corporation ("Kirby"), and a class action in behalf of its minority stockholders. The latter include plaintiffs whose Kirby stock is alleged to be worth over $110,000. Kirby was controlled and dominated by defendant Santa Fe Industries, Inc. and the latter's wholly owned subsidiary, defendant Santa Fe Natural Resources, Inc. (jointly "Santa Fe"). Santa Fe, which owned 95% of Kirby's stock was a fiduciary; Kirby and its minority stockholders Santa Fe's cestuis (122a).**

The complaint alleged the following fraudulent manipulative or deceptive scheme. In order deliberately to freeze the minority stockholder cestuis out of Kirby at a fraction of their true interest, Santa Fe, their faithless fiduciary, resorted to a Delaware short-form merger having no other substantial purpose. Santa Fe organized a dummy corporation which was then immediately merged into Kirby without prior notice to the stockholders. The minority in a fait accompli were allotted $150 cash per share for their stock, an intentionally undervalued price, unilaterally determined by Santa Fe which knew from its own appraisal that the stock was worth at least $772.00 per share (102a-103a, 142a, fn. 2). Santa Fe, the fiduciary, deliberately pocketed the difference, some $15,000,000.

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* Presence of the other ingredients of a 10b-5 violation (purchase-sale of a security via mails and interstate commerce) is not contested.

** Citations to "(a)" are to the separately bound Appendix filed by Petitioners.

There is no dispute as to the underlying facts.* In a nutshell:

(1) Appraisal Associates on February 19, 1974 had submitted to Santa Fe a written appraisal of the land (exclusive of minerals), timber, buildings and machinery belonging to Kirby as of December 31, 1973, stating its *market value to be $320,000,000* (102a, 128a, 82a-84a), *a critical fact completely omitted from petitioners' brief.* The *book value* of these assets was only $9,000,000. The difference of $311,000,000 was $622 per share over and above the book value of those assets of Kirby (102a). Adding the omitted market value of $622 per share to the $150 per share yields a fair value of $772 per share for Kirby's physical assets; the stock was worth at least that amount (102a).

(2) Sante Fe, as part of the scheme to defraud the minority stockholders of Kirby and with full knowledge of Appraisal Associates' opinion of the market value of Kirby's assets, obtained from defendant Morgan Stanley & Co. ("Morgan") in June 1974 a fraudulent appraisal valuing Kirby's stock at $125 per share (103a). Morgan was joined as a defendant with the allegation that it knowingly assisted and facilitated such fraud by submitting a written appraisal of the stock at $125 per share even though it reviewed the written appraisal by Appraisal Associates for $320,000,000 and knew the value of Kirby was at least $772 per share (103a, 80a-81a).** Santa Fe

* The case is at the earliest pleading stage, there having been no answer and no pre-trial discovery. The plaintiffs' claim is set forth in the amended complaint as enlarged by the Sante Fe Information Statement with its enclosures, sent to the stockholders *after* the merger (122a). Plaintiffs' allegations of fact and the reasonable inferences therefrom are, of course, taken to be true on the motion to dismiss; e.g., *Supt. of Insur.* v. *Bankers Life*, 404 U.S. 6; *Gardner* v. *Toilet Goods Ass'n*, 387 U.S. 167, 172.

** The Court of Appeals affirmed the dismissal as to Morgan; plaintiffs' petition for certiorari is now pending as Docket No. 75-1660.

in a self deal fixed the value of the Kirby minority shares at $150 per share in order to create the erroneous appearance that it was generous in fixing a value $25 higher than the Morgan appraisal (103a).

(3) In addition, Santa Fe arranged the transaction as tax-free to itself while imposing a capital gains tax on the Kirby minority stockholders (102a).

(4) For the sole purpose of getting rid of the minority interest in Kirby and not for any substantial corporate purpose, Santa Fe created Forest Products Inc. ("FPI"), a Delaware corporation, on July 11, 1974, to effect a statutory merger with Kirby under the color of the Delaware short form merger statute which authorized effectuation of the merger before notice to and without consent of the minority, and provision of payment in cash for the minority.

(5) *Without any notice or disclosure whatsoever to the minority stockholders of Kirby, or consent by them,* Santa Fe, on July 31, 1974, caused FPI to be merged into Kirby, freezing out the minority, with Kirby surviving the merger (100a). Kirby's purchase at $150 per share on July 31, 1974 was a forced sale by the minority to the fiduciary on that date, without even the knowledge of such minority stockholders (101a).

(6) By letter of August 1, 1974, *after** the merger had been completed effective the previous day, the minority stockholders of Kirby were *first* informed by Santa Fe that their only right was to receive a cash payment of $150 per share for their shares that were purchased by Kirby on July 31, 1974 or to seek an appraisal under Dela-

* The Court of Appeals, inadvertently at one point (129a), stated that the Information Statement was sent to the shareholders "*prior* to the merger" (129a), other parts of the opinion recognize the undisputed fact that it was sent "*after*" the merger *(passim)* (Emphasis supplied throughout unless otherwise noted).

ware law for the fair value of those shares (101a). Kirby's letter of August 1st to the stockholders consisted of the Notice of Merger of FPI, Inc. into Kirby (12a-14a) and an Information Statement about the merger (15a-98a). That Information Statement, *inter alia,* incorporated the written appraisal of Appraisal Associates for $320,000,000 (82a-84a) and Morgan's opinion that the fair market value of the Kirby stock was $125 per share (80a). Santa Fe submitted the Morgan appraisal to the stockholders in an attempt to disguise the unconscionableness of the $150 price. The Information Statement, which was the basis for plaintiffs' allegations in the amended complaint, in effect announced the fraud that had been consummated the previous day. Santa Fe's confession of the fraud, post the event, did not grant it immunity from suit under the 1934 Act. It does not matter whether the fraud is unearthed by minority stockholders or published by the faithless fiduciary. Disclosure in the context of Rule 10b-5(2) means *prior* to the merger, not after it. Judge Mansfield, in his concurring opinion, stated (148a):

> Here . . . disclosure *after* the merger has been consummated is virtually the equivalent of no disclosure at all, since it comes too late to enable the minority to invoke state law for protection against an unwarranted squeeze-out (original emphasis).

This is not a case where plaintiffs merely allege that in their opinion the market value of the stock was $772. On the contrary, plaintiffs' allegation of fair value is based on defendants' own written market appraisal of $320,000,000 for certain assets. With that knowledge, Santa Fe deceived and defrauded the 5% minority stockholders by intentionally* undervaluing their shares at $150 in a concealed forced sale by the minority stockholders to Kirby, through an abuse of Delaware's short form merger statute. That was also an intentional breach of Santa Fe's fiduciary duty. The fiduciary thus created a scheme under color of state law to deliberately misappropriate its cestuis' property in a security purchase-sale, to the tune of $15,000,000 (103a), without the knowledge or consent of the stockholder-beneficiaries and without prior notice of any kind to them.

* The intent to deceive, defraud, or manipulate is easily inferred from the knowing, gross disparity in price the fiduciary fixed, for its own advantage to its cestuis' prejudice, and from its abuse of a form with no purpose other than to misappropriate their property.

The above transaction, whereby the dominant stockholder, a fiduciary, fleeced the minority, its cestuis, in the purchase and sale of securities, implemented by the use of means or instrumentalities of interstate commerce including U.S. mail and telephone (103a) constituted a plain violation of Rule 10b-5 under the settled authorities. It disclosed Santa Fe's flagrant "intent to deceive, manipulate, or defraud" its cestuis in the stock acquisition, striking at the heart of Section 10(b) of the 1934 Act and SEC Rule 10b-5 thereunder, *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (103a).

The complaint asked that the merger be set aside and/or for other appropriate relief such as the fair value of the minority shares.

Defendants moved in the District Court, pursuant to Rules 12(b)(1) and (6), F.R.Civ.P., to dismiss the complaint for lack of subject matter jurisdiction and failure to state a claim upon which relief can be granted. The District Court granted this motion and therefore did not reach the alternative motion under Rule 9(b) to dismiss the complaint for alleged failure to state the fraud with sufficient particularity.

Appeal to the Court of Appeals duly followed. The Panel (Medina, Moore, and Mansfield, C.J.J.) reversed the District Court's dismissal of the complaint against Santa Fe (Moore, J. Diss'g), Santa Fe's petition for rehearing

en banc was denied. The Court of Appeals summarized its holding as follows (134a):

> We hold that a complaint alleges a claim under Rule 10b-5 when it charges, in connection with a Delaware short-form merger, that the majority has committed a breach of its fiduciary duty to deal fairly with minority shareholders by effecting the merger without any justifiable business purpose. The minority shareholders are given no prior notice of the merger, thus having no opportunity to apply for injunctive relief, and the proposed price to be paid is substantially lower than the appraised value reflected in the Information Statement.

Summary of Argument

The Court below correctly held that it was deception, manipulation, or fraud, within Section 10(b) of the 1934 Act and Rule 10b-5 thereunder, where the fiduciary appropriated its cestuis' stock through the abuse of a short form merger, without any purpose other than to mulct its cestuis, and without their knowledge or consent, willfully setting an unfair price at $150 per share although knowing from appraisals it caused to be made that the stock was worth at least $772 per share. This misappropriation is "a garden variety type of fraud" covered by Rule 10b-5. *Supt. of Insur.* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 11, n. 7, and numerous cases in the lower federal courts, as well as the common law tradition of fraud set forth by the Supreme Court e.g. in *SEC* v. *Capital Gains Bur.*, 375 U.S. 180, 193, and other authorities. Section 10(b) and Rule 10b-5, as shown by its language and history and legislative purpose, is not confined to misrepresentations and non-disclosure. *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185. Moreover, the fraud here included both misrepresentation and non-disclosure.

Since the manifest language and purpose of Section 10(b) and Rule 10b-5 is to cover all fraudulent misconduct in the purchase or sale of securities, embodying the "paramount federal interest in protecting shareholders", *SEC* v. *Natl. Securities, Inc.*, 393 U.S. 453, 463, and pursuant to the purpose of Congress to establish a "federal regulatory scheme governing transactions in securities" affecting commerce, *Ernst & Ernst, supra,* at 206, the federal courts will enforce the Rule "flexibly, not technically and restrictively" *Supt. of Insur., supra,* at 12, as the supreme law of the land, without regard to more limited state rules or remedies. *Supt. of Insur., supra,* at 12; *National Securities, supra,* at 463. Moreover, following a state procedure does not immunize fiduciaries if they abuse it, as "their powers are powers in trust", *Pepper* v. *Litton,* 308 U.S. 295, 306. The abuse of a state form can provide no defense for the violation of the substance sought to be protected by state law, *Graffam* v. *Burgess*, 117 U.S. 180, 186, and *a fortiori* by the federal enactment. *Supt. of Insur., supra.*

ARGUMENT

The transaction was an intentional deception, manipulation or fraud within Rule 10b-5 under Section 10(b) of the 1934 Act.

The purpose of Santa Fe's purchase of securities from the minority stockholders of Kirby in a forced sale was an intentional appropriation by the fiduciary of its cestuis' property at a price unilaterally fixed by the fiduciary and known by the fiduciary to be only a small fraction of its true value. Hence there is no doubt that the standard of *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 of intent to defraud, manipulate or deceive has been met and Rule 10b-5 under Section 10(b) of the 1934 Act applies.

Section 17(a) of the 1933 Act

The language and purpose of Section 17(a) of the 1933 Act demonstrate that the transaction was in violation of the parallel Rule 10b-5 under Section 10(b) of the 1934 Act.

Section 17(a) expressly prohibits the sale of securities by means of (1) "any device, scheme, or artifice to defraud" or (2) "any untrue statement of a material fact or any [material] omission" or (3) "any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser". Since clause (2) expressly includes misrepresentations and omissions, it is evident that Congress in enacting clauses (1) and (3) intended to cover frauds or deceptions that might not come under the category of misrepresentations or omissions. This is also borne out by the use of phrases like "any device, scheme or artifice" or "transaction, practice or course of business", phrases which by their ordinary meaning include misconduct other than statements or silence.

That Section 17(a) is not confined to misrepresentations and non-disclosure is also borne out by the overall purpose of the 1933 Act. As stated in *Ernst & Ernst, supra,* 425 U.S., at 194-195:

> Federal regulation of transactions in securities emerged as part of the aftermath of the market crash in 1929. The . . . 1933 Act . . . was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, *to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing.*

A comparison of Section 17(a) with Section 11(a) and Section 12(2), the other antifraud provisions of the 1933 Act, further demonstrates that Section 17(a) goes beyond

misrepresentations and non-disclosure. Both Sections 11(a) and 12(2) cover only misrepresentations and omissions, which are covered by clause (2) of Section 17(a); and neither Section 11(a) nor Section 12(2) has any clause similar to clauses (1) and (3) of Section 17(a).*

Rule 10(b)(5), First and Third Clauses

With the two narrow antifraud provisions and one comprehensive antifraud provision, which included three enumerated clauses, of the 1933 Act before it in the consideration and enactment of the 1934 Act, Congress, rejecting the narrow approach, enacted the broad antifraud provision of Section 10(b) but without the enumeration of the specific clauses of Section 17(a) of the 1933 Act. Instead of that specific enumeration Congress in Section 10(b) authorized the SEC to enumerate specific instances of manipulative and deceptive devices. As the Supreme Court has noted, the legislative history of Section 10(b) shows it was intended as a "catch-all", to proscribe "any other cunning devices" that operate as a fraud in connection with the purchase and sale of securities, *Ernst & Ernst, supra,* 425 U.S., at 202 and 203. If Congress had intended to confine the antifraud provisions of Section 10(b) to misrepresentation and non-disclosure, it is evident that it would not have used a catch-all provision, but would have reenacted the narrow antifraud provisions of Sections 11(a) and 12(2) of the 1933 Act and the Court in *Ernst & Ernst* throughout its

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* Section 11(a) (15 U.S.C. § 77k(a)) proscribes a registration statement containing "an untrue statement of a material fact or [one that] omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading."

Section 12(2) (15 U.S.C. § 771) proscribes the sale of a security by a "communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading".

opinion referred to 'deception, manipulation or fraud' and to words like 'practices' and conduct'—all terms which are more comprehensive than misrepresentation and omission.

The SEC, under the authority of Section 10(b), issued Rule 10b-5 which is virtually identical with the three specific clauses of Section 17(a) of the 1933 Act. See *Ernst & Ernst, supra,* 425 at 213, n. 32.* It is entirely clear therefore that Section 10(b) with Rule 10b-5 was intended to have at least as broad a scope as Section 17(a) of the 1933 Act, but applicable to purchasers as well as sellers of securities.

This Court's opinion in *Ernst & Ernst* stated, with respect particularly to Section 10(b), that

> Congress recognized that efficient regulation of securities trading could not be accomplished under a rigid statutory program. As part of the 1934 Act Congress created the Commission, which is provided with an arsenal of flexible enforcement powers (425 U.S., at 195).

As with 17(a) of the 1933 Act, Rule 10b-5 clause 2 expressly includes misrepresentations and omissions, so that clauses 1 and 3 plainly refer to frauds that need not constitute misrepresentation or omission.

The opinion in *Ernst & Ernst* gives further support to the position that Section 10(b) is not confined to misrepresentation or non-disclosure.** Thus the Court stated (*id.* at 197) as follows:

> Section 10(b) makes unlawful the use or employment of "any manipulative or deceptive device or contrivance" in contravention of Commission rules. The words "manipulative or deceptive" used in conjunction with "device or contrivance" strongly suggest that Section 10(b) was intended to proscribe knowing or intentional *misconduct.*

Clearly this language cannot be restricted to misreprentations or omissions to state.

The Court further stated as follows (*id.* at 199):

> Use of the word "manipulative" is especially significant . . . It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.

That describes precisely what the defendants did in our case. As fiduciaries they engaged in intentional or willful conduct designed to deceive or defraud their cestuis by controlling the price of the securities, unilaterally fixing the price at which they knowingly misappropriated the stock at 20% of its value, to their manifestly unfair advantage and to the prejudice of the stockholders.*

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* 10b-5 was in fact originally inspired by purchasers' fraudulent and deceitful activities related to an upswing in the economy and to consequent takeovers by insiders of their cestuis' equity (*Ernst & Ernst, supra,* at 212-213, n. 32; 1 Bromberg, Securities Law—Fraud pp. 22.8-22.9).

** Indeed, what was complained of against the defendant Ernst & Ernst was the breach of a duty to inquire (*id.* at 191) which

(footnote continued on following page)

(footnote continued from preceding page)

is neither misrepresentation nor non-disclosure; the Court implicitly held that an intentional failure to inquire, for the purpose of manipulation, fraud or deception would have been a violation of Section 10(b) and Rule 10b-5.

* The "*Schoenbaum* court [405 F2d 215 (2d Cir. *en banc*)] appears to have recognized, as the securities laws in other areas have recognized, that it is possible to manipulate transactions, not only through deception and the withholding of material information, but also through the use of controlling influence. Thus the *Schoenbaum* court's holding that the use of controlling influence in a corporation can be an 'act, practice or course of business which operates . . . as a fraud' seems to be a realistic interpretation of rule 10b-5." Note, *The Controlling Influence*

(footnote continued on following page)

The Court also quoted from Webster's Int'l Dictionary, which, in part, defines "manipulate" as ". . . to manage or treat artfully or fraudulently" *id.* at 199, n.21. The conduct complained of here falls squarely within that definition, in that the fiduciary defendants managed their power over their beneficiaries' stock fraudulently.

The Court in *Ernst & Ernst* stated further (*id.*, at 206):

> The Report therefore reveals with respect to the specified practices, an overall congressional intent to prevent "manipulative and deceptive practices . . . which fulfill no useful function" and to create private actions for damages stemming from "illicit practices" where the defendant has not acted in good faith.

Again, this language aptly describes the misconduct complained of in our case.

The Court in *Ernst & Ernst* in its brief discussion of the three clauses of Rule 10b-5 taken severally (at 212) characterized subsection 2 as proscribing "any type of material misstatement or omission" and subsection 3 as proscribing "any course of conduct, that has the effect of defrauding investors"—an explicit recognition that clause 3 goes beyond clause 2 in proscribing fraudulent conduct other than misrepresentation or non-disclosure.

Finally, the Court in *Ernst* noted (id., at 212):

> that when the Commission adopted the rule it was intended to apply only to *activities* that involved scienter.

(footnote continued from preceding page)

Standard In 10b-5 Corporate Mismanagement Cases. 86 Harv. L. Rev. 1007, 1036. The Court below explained the *Schoenbaum* decision as follows (132a): "Breach of fiduciary duty and fraud on the *cestuis* and the corporation had been committed, on the facts as alleged, when Banff sold its shares to Aquitaine at an inordinately low price after the directors had learned of the important oil discovery and before that information had been made public, even though there had been neither misrepresentation nor failure to make any required disclosure to the minority."

"Activities", as the enumeration of the three clauses shows, included (clause 2) misrepresentations and non-disclosure and (clauses 1 and 3) also included any other kind of fraud practiced upon purchasers or sellers of securities.*

Section 17(a) of the 1933 Act and Section 10(b) of the 1934 Act with Rule 10b-5 thereunder must of course be construed together in the light of their common purpose. In *Ernst & Ernst,* this Court referred to "the overall congressional purpose in the *1933 and 1934 Acts* to protect investors against false and deceptive *practices* that might injure them." 425 U.S., at 198.** The Court stated further, *id.* at 206, in this connection as follows:

> The 1933 and 1934 Acts constitute interrelated components of the federal regulatory scheme governing transactions in securities . . . the interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen . . .

Plainly Section 10(b) and Rule 10b-5 are not to be interpreted any more narrowly than the comprehensive antifraud provision of Section 17(a) of the 1933 Act.

* The Court in *Ernst,* noting the use of the word "device" in Section 10(b) and clause 1 of Rule 10b-5, quoted (*id.* at 199, n. 20) Webster's Int'l Dictionary definition of "device" as "[t]hat which is devised, or formed by design; a contrivance; an invention; project; scheme; often, a scheme to deceive; a stratagem; an artifice". The Court, continuing, quoted Webster's definition of "contrivance", used in Section 10(b), as "[a] thing contrived, or used in contriving; a scheme, plan, or artifice." "In turn, 'contrive' in pertinent part is defined as '[t]to devise; to plan; to plot . . . [t]o fabricate . . . design; invent . . . to scheme . . .'". The Court also noted the use of the terms in Section 10(b) "[t]o use or employ". The corresponding words are, in clause 1 "to employ" and in clause 3 "to engage". These terms, of course, aptly refer broadly to misconduct that is not limited to misrepresentation and non-disclosure.

** Accord: *United Housing Found.* v. *Forman*, 421 U.S. 834, 847; *Radzanower* v. *Touche, Ross & Co.*, —— U.S. ——, 48 L.Ed.2d 540, 547.

The Supreme Court has already held that Rule 10b-5 goes beyond statements and silence to other fraudulent practices by a fiduciary in the purchase or sale of securities. *Supt. of Insurance* v. *Bankers Life,* 404 U.S. 6 applied the 1st and 3rd clauses of Rule 10b-5 which proscribe nonverbal frauds (404 U.S., at 9) and held that "misappropriation is a 'garden variety' type of fraud" *id.* at 11, n. 7, within the language and contemplation of the Rule and Section 10(b). That case squarely applies to ours. The only difference is that there the fiduciary pocketed all the proceeds and here the fiduciary misappropriated "only" 80% of the value of its cestuis' stock, some $15,000,000. In *Sup't of Insurance,* the Court stated, too, that "The Congress made clear that 'disregard of trust relationships by those whom the law should regard as fiduciaries, are all a single seamless webb' along with manipulation, investor's ignorance, and the like." (404 U.S., at 11-12).

Likewise, in *Affiliated Ute Citizens* v. *U.S.,* 406 U.S. 128, 152-3, the Court stated:

> To be sure, the second subparagraph of the rule [10b-5] specifies the making of an untrue statement of a material fact and the omission to state a material fact. The first and third subparagraphs are not so restricted.

This Court has already defined the scope of the "fraud" concept in the federal securities laws. In *SEC* v. *Capital Gains Research Bureau, Inc.,* 375 U.S. 180, 193, the Court set forth the following as the applicable standard of what constitutes fraud for the purposes of the securities laws:

> [E]quity regarded it [fraud] as a conveniently comprehensive word for the expression of a lapse from the standard of conscientiousness that it exacted from any party occupying a certain contractual or fiduciary relation toward another party.

And the Court below (131a) cited *Capital Gains Research Bureau Inc.,* at 194, as quoting from *Moore* v. *Crawford,* 130 U.S. 122, 128 (1888):

> Fraud, indeed, in the sense of a court of equity properly includes all acts, omissions and concealments which involve a breach of legal or equitable duty, trust, or confidence, justly reposed, and are injurious to another, or by which an undue and unconscientious advantage is taken of another.

Plainly Santa Fe's resort to the form of a merger for the deliberate purpose of misappropriating most of the value of its cestuis' stock constitutes "fraud . . . in the sense of a . . . breach of . . . equitable [fiduciary] duty . . . by which an undue and unconscientious advantage is taken of another." Santa Fe's imposing on the minority a sale to itself, against their will, at $150 per share, the fiduciary knowing the stock's value is in excess of $772 per share, is conclusively "an undue and unconscientious advantage", an intentional breach of its fiduciary duty and thus a fraud. The Supreme Court's 1888 case of *Moore* v. *Crawford, supra,* demonstrates that a wilful breach of fiduciary duty under such circumstances is a classic case of "fraud" long established in the law. As long ago as 1850 the Supreme Court in *Taylor* v. *Taylor,* 49 U.S. 183, 199-200, quoting Mr. Justice Story's treatise on equity jurisprudence with approval, stated:

> speaking of frauds which "arise from some peculiar confidence or fiduciary relation between the parties", he remarks, In this class of cases there is often found some intermixture of deceit, imposition, overreaching, unconscionable advantage, or other mark of direct and positive fraud. But the principle on which courts of equity act in regard thereto stands independent of any such ingredients, upon a motive of public policy . . . [namely that the fiduciary seeks] to derive advantage from that circumstance.

The Court in *Capital Gains Research Bureau* held at 181, *inter alia,* that scalping is a species of fraud.* In that case, involving specifically the Investment Advisers Act, the defendant argued that non-disclosure was not prohibited by the relevant provision, 15 U.S.C. § 80b-6, because that section, which contains clauses similar to clauses (1) and (3) of Section 17(a) of the 1933 Act, does not contain a misrepresentation or non-disclosure clause such as clause (2) of section 17(a).** The Supreme Court, rejecting that argument, stated that *"any practice* which operates 'as a fraud or deceit' " includes non-disclosure "as *one* variety" thereof (198-199).

Moreover, even at common law,*** fraud is not confined to misstatements or omissions to state.**** Thus, the

* Scalping is purchasing a security shortly before recommending it and selling immediately after—a practice that need not involve misstatements to the victim or non-disclosure; i.e., omission from a statement to him.

** Section 80b-6 refers to fraud or deception by "any device, scheme or artifice" or "any transaction, practice or course of business".

*** ". . . the courts have adapted the common law of fraud to the commercial transactions of our society." *Capital Gains Research Bureau, supra,* 375 U.S., at 192. Of course, there is "some relationship" between the statutory anti-fraud provisions and the common law. *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723, 724.

**** e.g. 12 Williston on Contracts (Jaeger ed.), pp. 321-2, 330-1, 332; Bouvier's Law Dict. (Rawle's Third Rev.), entry "FRAUD": it includes "any cunning, deception, or artifice, used to circumvent, cheat, or deceive another." As Prosser stated in discussing fraud by conduct, "actions may speak louder than words." *Torts* (4th ed., 1971) pp. 694-5.

The first meaning of "fraud" in the Random House Dict. of the Eng. Lang. (Unab. Ed.) p. 564, is "1. deceit, trickery, sharp practice, or breach of confidence, used to gain some unfair or dishonest advantage."

As long ago as 1201, a writ of deceit could be sued out against a defendant "who had misused legal procedure for the purpose of swindling someone." Prosser *Id.,* p. 685.

fiduciary's misappropriation* of his cestui's property is, of course, also a fraud at common law, even if there were no misstatements or omissions to state. *Grin* v. *Shine,* 187 U.S. 181, 189, 195.

The authorities uniformly agree that a fiduciary's taking unfair advantage of his cestui is, without more, a species of fraud at common law. E.g. Amer. Jurisp. 2d "Fraud and Deceit": action for fraud and deceit maintainable where fiduciary does not exercise "the utmost good faith in the transaction" or he obtains an unfair advantage "whether the unconscionable advantage was obtained by misrepresentation, concealment or suppression of material facts, artifice, or undue influence" (§ 15, pp. 38-39). "[I]f in a transaction between parties who stand in a relationship of trust and confidence, the party in whom the confidence is reposed obtains an apparent advantage over the other, he is presumed to have obtained that advantage fraudulently" (§ 441, p. 602). "The obtaining property or of any benefit through the medium and unconscientious abuse of influence by a person in whom trust and confidence are placed is a fraud of the gravest character." Citing *Moxon* v. *Payne* (1873), L.R. 8 Ch. 887, Kerr, (7th Ed. McDonnell & Monroe 1952) *A Treatise on the Law of Fraud and Mistake,* at pp. 185-6.**

Indeed, at common law, even in the absence of a fiduciary relationship, the "inadequacy of consideration may be so

* "Misappropriate"—"To appropriate wrongly or misapply in use, especially wrongfully and for oneself". Webster's New International Dictionary, 2nd Ed., Unabridged.

** Accord: 3 Pomeroy's Equity Jurisp. (5th ed. Symons) p. 421; Prosser on Torts (4th ed. 1971) p. 697. At common law, a strict Trustee may in no event buy his cestui's property, from himself because of the temptation to defraud (Bogert, Trusts and Trustees (2d ed.) § 543, n.2.10). *Kerr, supra,* p. 1: "The fertility of man's invention in devising new schemes of fraud is so great that the Courts have always declined to define it or to define undue influence, which is one of its many varieties . . ."

flagrant as of itself to afford a presumption of fraud." Am. Jurisp.2d, *supra,* at § 440, p. 601. Accord: 3 Pomeroy, *supra,* § 927, p. 634. "Inadequacy of consideration is therefore a badge of fraud." Kerr, *supra,* p. 365; also p. 225. If the disproportion is great enough it may furnish "decisive *evidence of fraud.*" Pomeroy *Id.* Here Santa Fe appropriated 80% of the minority's stock value. The disproportion becomes even more significant as to "the fact of fraud" because there was no "deliberation by the parties [seller and purchaser]", Pomeroy, *supra,* § 928, p. 637—Santa Fe having fixed the price unilaterally and effected the transaction for Kirby without the knowledge or consent of the public stockholders.*

As the Court below held (124a-126a):

> But only subdivision (2) of 10-5 deals with nondisclosure and misrepresentation. The Rule contains two other subdivisions which state explicitly that fraud other than and in addition to a failure to disclose or truthfully represent is also actionable. . . .
>
> As with other laws Rule 10b-5 must be interpreted and applied so as to accomplish the purpose for which it was intended. That this requires a generous reading is too obvious for comment. Since the time to which the memory of man runneth not to the contrary the human animal has been full of cunning and guile. Many of the schemes and artifices have been so sophisticated as almost to defy belief. But the ordinary run of those willing and able to take unfair advantage of others are mere apprentices in the art when compared with the manipulations thought up by those connected in one way or another with transactions in securities. This is especially true of schemes that seem to be absolutely safe but offer rich rewards. In these days when there are takeovers and tender offers galore, times when those who used to think of going public now think of becoming private again, it is especially imporant to give Rule 10b-5 its full scope. If this is to be done, the enforcement of the fiduciary duty owed by the majority to the minority in corporations large and small should not be overlooked. . . .
>
> * * * *

Judge Mansfield, concurring, stated in part as follows (144a-145a):

> . . . The short-form merger, when used to squeeze out small public investors by forcing them to relinquish their corporate investments at low prices for no purpose other than to benefit the insiders, can accurately be characterized as a "manipulative or deceptive device or contrivance," *id.* [*Supt. of Insur.,* 404 U. S.] at 10, which interferes with the interests of the public shareholders in the most fundamental of ways, by depriving the investor of his very interest in his corporate investment. It also undercuts the broader purpose of "preserving the integrity of the securities markets," *id.* at 12, for a clearer instance of potential abuse of the market processes cannot be found.

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* Accord: *Graffam* v. *Burgess,* 117 U.S. 180, 192:

> Great inadequacy requires only slight circumstances of unfairness in the conduct of the party benefiited by the sale to raise the presumption of fraud.

Kerr, supra, at p. 226:

> But inadequacy of consideration . . . becomes a most material circumstance when one of the parties to a transaction is . . . unable to protect himself. In all such cases, *whatever be the nature of the transaction,* the onus of proof rests on the party who seeks to uphold it to show that the other party performed the act or entered into the transaction voluntarily, and deliberately, knowing its nature and effect, and that his consent to perform the act or become a party to the transaction was *not* obtained by reason of any undue advantage taken of his position or of any undue influence exerted over him.

> To immunize the short-form merger from the coverage of Rule 10b-5 merely because state law has authorized the device to be used for the purpose of squeezing out the public shareholders without giving them prior notice or an opportunity to obtain injunctive relief would be to ignore the central protective purposes underlying federal securities legislation and to countenance an anomalous result. Those who are most exposed and most vulnerable—the small outside public shareholders who are not privy to the inner workings of the corporate enterprise and who are forced to accept a unilaterally imposed result—would be the least protected. If they are to enjoy the protection intended to be furnished by 10b-5, that rule must not be interpreted in a technical or niggardly fashion.

Many cases in the lower courts have also found non-verbal fraudulent or deceptive acts; i.e. other than misstatements or omissions, to be violative of 10b-5, particularly in securities transactions between fiduciaries and their beneficiaries and between others in relations of confidence. E.g., *Schoenbaum* v. *Firstbrook,* 405 F2d 215 (2nd Cir., en banc), cert. den. 395 U.S. 906, inadequate price paid by controlling stockholder to corporation for stock, with inside knowledge of the true value, violates 10b-5.* Here, we

* Accord: *Drachman* v. *Harvey,* 453 F2d 736 (2nd Cir., en banc), where fiduciary knowingly caused corporation to make improvident redemption of its convertible securities, that was a violation of 10b-5; *Marshel* v. *AFW Fabric Corp.,* 533 F2d 1277 (2nd Cir.) vacated and remitted on another ground, sham merger violates 10b-5; *Mutual Shares Corp.* v. *Genesco, Inc.,* 384 F2d 540 (2nd Cir.), reduction of dividends in order to effect reduction in market price of stock violates 10b-5; *Schlick* v. *Penn-Dixie Cement Corp.,* 507 F2d 374 (2nd Cir.), cert. den. 421 U.S. 976, market manipulation violates 10b-5; *Pappas* v. *Moss,* 393 F2d 865, 869 (3d Cir.), "where, as here, a board of directors is alleged to have caused their corporation to sell its stock to them and others at a

(footnote continued on following page)

have all the necessary ingredients of a fraudulent scheme as in *Schoenbaum* (at 218-219), to wit, "control, [Santa Fe's] knowledge [of the underlying pro rata value of the physical assets of Kirby], the inadequacy of the price paid for the stock . . ." We have found no cases to the contrary.

Judge Hays had previously dissented in part from the panel's decision in *Schoenbaum,* 405 F2d 200 (C.A.2), then wrote the reversing opinion for the *en banc* Court in *Schoenbaum,* 405 F2d 215, which essentially followed his earlier dissenting panel opinion. In that earlier opinion,

(footnote continued from preceding page)

fraudulently low price, a violation of Rule 10b-5 is asserted"; *Speed* v. *Transamerica Corp.,* 235 F2d 369 (3d Cir.), inadequate consideration paid by the control group for stock violates 10b-5; *Shell* v. *Hensley,* 430 F2d 819, 827 (5th Cir.), the unfair use of controlling influence in the purchase or sale of securities spells out a fraud under 10b-5; *Rekant* v. *Desser,* 425 F2d 872, 882 (5th Cir.),

> "We conclude, therefore, that when officers and directors have defrauded a corporation by causing it to issue securities for grossly inadequate consideration to themselves or others in league with them or the one controlling them, the corporation has a federal cause of action under § 10(b) . . . . The essence of the transaction is not significantly different from fraudulent misrepresentation perpetrated by one individual on another";

Hooper v. *Mountain States Securities Corp.,* 282 F2d 195, 204 (5th Cir.) cert. den. 365 U.S. 814, "the essence of the" 10b-5 "fraud" was "a scheme to get Consolidated to issue . . . stock for worthless property." *Dasho* v. *Susquehanna Corp.,* 380 F2d 262, 270 (7th Cir.), the concurring majority sustained a complaint that a self-deal merger on unfair terms violates 10b-5; *Travis* v. *Anthes Imperial Ltd.,* 473 F2d 515, 527 (8th Cir.), Rule 10b-5 liability found even though "[t]he essence of the plaintiffs' complaint . . . is that the defendants violated § 10(b) and Rule 10b-5 by engaging in self-dealing. . . . Here, as in *Sup't of Insurance,* the defendants' self-dealing was a violation of a fiduciary obligation to minority shareholders . . ."; *Norris & Hirshberg, Inc.* v. *SEC,* 177 F2d 228 (U.S. Ct. App., D.C.), broker's purchases from, and immediate resales to, trusting customers, at higher prices, violates 10b-5 as fraud on customers. For further cases in accord, see VI Loss, *Securities Regulation,* Supp. to 2nd Ed. (1969), Sec. (vi) "Violation by non-verbal acts", pp. 3602-5.

Judge Hays stated with respect to the bargain sale of stock to the insider (215):

> What we have here then is a scheme by which the directors of Banff gave to the controlling stockholder (footnote omitted) and an affiliated corporation some millions of dollars worth of this corporation's property. *A plainer case of fraud would be hard to find.*

With respect to fraud through self-dealing, Judge Mansfield below stated the following:

> Our conclusion that where there has been self-dealing on the part of corporate insiders, proof of misrepresentation or non-disclosure is not a *sine qua non* to the establishment of 10b-5 liability is shared by other Circuits (150a).*

After citing and quoting from several cases, Judge Mansfield continued as follows:

> Defendants' efforts to reconcile these decisions by searching for some misrepresentation or non-disclosure ignores the court's plain language in each case and exalts form over substance. Such misrepresentations as may be found generally related to technical, trivial matters, having little or no relevance to the manipulative conduct giving rise to 10b-5 liability. Furthermore, in some of the cases the courts, in imposing § 10(b) liability were quite explicit in acknowledging the absence of misrepresentation or openly minimizing its import to the illegal conduct under challenge (152a).

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* The self-deal assumes (142a fn. 2) "for the purposes of this appeal . . . that the $150 per share offered by Kirby to the public shareholders is inadequate and that the correct buy-out price equals $772 per share, a sum derived by a pro-rata division of Kirby's appraised assets".

Here there was no economic reality to the merger. A paper corporation was created and immediately "merged" into Kirby Lumber as a mere device whereby Santa Fe, the majority holder, could squeeze out the Kirby minority at a small fraction of the true value of the minority's stock. As the Sixth Circuit U.S. Court of Appeals stated (*Marsh* v. *Armada Corp.*, 533 F2d 978) in explaining the 2nd Circuit's decision below:

> In *Green* . . . the merger was a sham transaction designed to expropriate the ownership interests of the minority shareholders (at page 986)—

at a small fraction of their value. The sham merger as a device to misappropriate the beneficiary's property was, plainly, a fraudulent and deceptive act, practice or scheme under the decisions of the Supreme Court and the other federal courts.

Santa Fe is itself a public corporation with outside stockholders; that was not changed by the merger of a dummy corporation into Kirby. All that happened was that a public entity squeezed out some members of the public and continued as a public going concern. Sante Fe, had it acted in good faith and without intent to overreach in the merger, could have offered the Kirby minority Santa Fe stock, tax-free (at a fair price) and thus a continuing interest in the enterprise—this is recommended by Professor Arthur H. Borden, *Going Private—Old Tort, New Tort or No Tort?* N.Y.U. Law Rev. Preprint (1974), at 1018-9. Here, the majority stockholder arranged the security transaction in such way as to be tax-free to itself but not to the minority, who, receiving cash, must report and pay a capital gains tax (75A). This disparate treatment favoring the fiduciary and discriminating against the cestui, without notice or compensation to or consent by the minority, was further fraudulent overreaching in violation of Rule 10b-5.

In *Lebold* v. *Inland Steel Co.*, 125 F2d 369, 136 F2d 876 (C.A.7) the insiders were held liable for having used dis-

solution proceedings, authorized by statute, for the purpose of eliminating minority stockholders from the profits to be made from the continuation of a going concern:

> Whether we stamp the happenings as dissolution or with some other name, equity looks to the essential character and result to determine whether there has been faithlessness and fraud upon the part of the fiduciary. However proper a plan may be legally, a majority stockholder can not, under its color, appropriate a business belonging to a corporation to the detriment of the minority stockholder. The so called dissolution was a mere device by means of which defendant appropriated for itself the transportation business of the Steamship Company to the detriment of plaintiffs. *That the source of this power is found in a statute, supplies no reason for clothing it with a superior sanctity, or vesting it with the attributes of tyranny.* Allied Chemical & Dye Corp. v. Steel & Tube Co. of America, 14 Del. 1, 120 A. 486. The books are full of instances of disapproval of such action.

A sham merger merely to eliminate a minority stockholder has been held to be a fraud against him at common law, *Bryan* v. *Brock & Blevins Co.*, 490 F2d 563, 570-571 (5th Cir.) cert. den., 419 U.S. 844, and in New York under the Martin Act, *Peop.* v. *Concord Fabrics, Inc.*, 50 AD2d 787 (1st Dept.) aff'g on op. below, 83 M 2d 120, involving the same merger invalidated under 10b-5 in *Marshel* v. *AFW Fabric Corp.*, 533 F2d 1277 (2nd Cir. 1976) vacated and remanded on another ground.

Moreover, the Fraud Here Also Included Misrepresentation and Non-Disclosure

In addition, a fiduciary implicitly represents that he will deal with his cestui fairly and in good faith. The fiduciary's willful and unconscionable misappropriation of its cestui's property in the forced purchase of the cestuis' Kirby stock constituted an intentional misrepresentation within clause 2 of Rule 10b-5.*

Further, a material part of Santa Fe's scheme consisted in obtaining a fraudulent appraisal from Morgan and in persuading the minority stockholders that the $150 it had unilaterally fixed for each share was fair; that would deter challenges in the courts. To that end it paid Morgan $125,000 for Morgan's undervaluation of Kirby stock at $125, worth at least $772 per share, when Morgan knew that the pro rata market value of Kirby's physical assets was $772 per share (103a). By transmitting the dishonest appraisal to the stockholders, Santa Fe adopted, and made its own, a misstatement, as part of its fraudulent scheme.

Furthermore, as noted, the transaction was consummated without the prior knowledge or consent of the stockholders and accordingly there was material non-disclosure. The first time the stockholders heard of the merger and the taking of their stock was when Santa Fe informed them that their stock had already been taken by Santa Fe at $150 per share and if they didn't like it their only remedy was an appraisal proceeding. As Judge Mansfield held below (147a-148a):

> Defendants place heavy reliance upon *Popkin* v. *Bishop*, 464 F.2d 714 (2d Cir. 1972), as representing a departure from our steady trend toward an expansive view of the reach of the federal security laws. However, to the extent that *Popkin* is at all relevant to the short-form merger context, it impliedly supports the application of the *Schoenbaum-Drachman* rule to this case. In *Popkin*, unlike the present case, *prior* stockholder approval of the proposed merger

* *U.S.* v. *George*, 477 F2d 508, 513 (7th Cir. 1973): "Here the fraud consisted in Yonan's holding himself out to be a loyal employee, acting in Zenith's best interests, but actually not giving his honest and faithful services, to Zenith's real detriment." (mail fraud, 18 USC § 1341).

was required. Full *advance* disclosure of the relevant facts regarding the merger exchange ratios to the minority stockholders was effective protection because it gave them the opportunity, as Judge Feinberg noted, to seek state court injunctive relief which was purportedly available under Delaware law. *Id.* at 720. Here, in contrast, disclosure *after* the merger has been consummated is virtually the equivalent of no disclosure at all, since it comes too late to enable the minority to invoke state law for protection against an unwarranted squeeze-out. Indeed, it is well recognized that the state post-merger appraisal procedure does not provide an alternative remedy comparable to federal relief. (original emphasis; footnotes omitted)*

The authorities are in accord with the decision below that only disclosure before the fact could in any event give the kind of investor protection contemplated by the antifraud provisions of the securities laws.** Thus, Harlan, J., explaining why purchase, cheap, by the control, on inside information, violated 10b-5 (*Speed* v. *Transamerica Corp.*,

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* Petitioners' reliance on *Popkin* v. *Bishop* (PBr. 11-12) is also misplaced because there there was no indication of any intention by the fiduciary to use the merger as a pretext to cheat the minority; the longterm merger it proposed, far from being a sham, was, in the words of the Court below, "as a practical matter compelling" (135a). Further, as Medina, C.J. stated, below (135a-136a):

> The plain implication [of *Popkin*] is that in cases such as the short-form merger, where no shareholder approval is required, there is no need for a showing of misrepresentation or lack of disclosure to make out a 10b-5 case. . . . Whether full disclosure has been made is not the crucial inquiry since it is the merger and the undervaluation which constitute the fraud, and not whether or not the majority determines to lay bare their real motives.

** Though a non-verbal fraud may not be neutralized even by advance disclosure, *Marshel* v. *AFW Fabric Corp., supra,* 533 F2d, at 1282.

235 F2d 369) stated:

> Had shareholders been aware of the concealment, they would undoubtedly have refused to sell. *Capital Gains Bureau, supra,* 375 U.S. 180, at 205 (dissg. op.).

The disclosure must be in advance so that the investor can protect himself by preventing the sale on the terms given, *Affiliated Ute Citizens* v. *U.S.*, 406 U.S. 128, 153. Telling him after the sale is shutting the barn door after stealing the horse. So in *Bailey* v. *Meister Brau, Inc.*, 535 F2d 982 (7th Cir. 1976), the Court held that it was a violation of 10b-5 for "the controlling stockholder [to cause] the corporation to engage in a securities transaction in which the stockholder has a conflict of interest [and which] was unfair to the corporation," because he had not disclosed information "which reflects on the fairness of the transaction" to "the only stockholder whose interests lay with the corporate entity":

> He was thus deprived of any opportunity to protect the interests of the corporation and of himself as minority shareholder (p. 993).*

Therefore, plaintiffs also established a violation of Rule 10b-5, Clause 2, misrepresentation and nondisclosure.**

Santa Fe implicitly acknowledges that *Schoenbaum* was correctly decided and states (p. 15, fn.) *there* "the defend-

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* Cf. *Nader* v. *Allegheny Airlines,* —— U.S. ——, 48 L. Ed. 2d 643, a common law action of fraud and deceit was maintainable by a passenger for nondisclosure by an airline of its overbooking practice which resulted in his being bumped, even though he was subsequently informed that by reason of the overbooking he could obtain compensation for the bumping.

** Nondisclosure, here, was also a part of the "device, scheme or artifice to defraud" under clause 1 and part of the "act, practice or course of business which operates . . . as a fraud or deceit upon any person" under clause 3 of 10b-5. See *Capital Gains Research, supra,* 375 U.S., at 198-199.

ants had caused the corporation to sell stock at an unreasonably low price, without disclosing that they had inside information of a major oil discovery which would greatly increase the value of the shares." But *here*, on July 31, 1974, "the defendants had caused [Kirby] to [buy] stock at an unreasonably low price, without disclosing that they had inside information of [an appraisal] . . . which would greatly increase the value of the shares" to $772 per share. So *Schoenbaum* squarely applies.

Santa Fe's reference (p. 15, fn.) to *Voege* v. *American Sumatra Tobacco Corp.*, 241 F.Supp. 369 (D. Del. 1965), states (p. 15, fn.):

> the defendants had acquired their 90% position through a tender offer, in connection with which they concealed the fact that they planned a partial liquidation of assets which would result in a higher yield per share than the total price being offered (241 F.Supp. at page 373).

Here, defendants acquired 100% of Kirby through a short form merger, "in connection with which they concealed the fact [on July 31, 1974] that they [in effect, carried out a] liquidation of assets which would result in a higher yield per share" than the price being paid to the minority. So *Voege* squarely applies. Defendants' confession of the fraud, on August 1, 1974 the day after its consummation, does not immunize them from liability.

The Decision Below Against Santa Fe Gives Proper Effect To "The Federal Regulatory Scheme Governing Transactions In Securities".

In *Ernst & Ernst, supra,* the Supreme Court gave decisive effect to the express language of Section 10(b) and Rule 10b-5, as suported by the purpose and legislative history of the 1934 Act. Since the manifest language and purpose of Section 10(b) and Rule 10b-5 is to cover all fraudulent misconduct in the purchase or sale of securities, that should be the end of the inquiry. Section 10-b is a mandate of Congress and Rule 10b-5 was validly promulgated thereunder. The federal courts will therefore enforce it "flexibly, not technically and restrictively." *Supt. of Insur., supra,* 404 U.S., at 12. Under Article VI clause 2 of the U.S. Constitution, Section 10(b) and Rule 10b-5 are the supreme law of the land.* Moreover, the abuse of a state form provides no defense for a violation of the substance sought to be protected by the federal enactment.

Delaware, in allowing a short form merger, did not purport to license fraud. In *David J. Greene & Co.* v. *Schenley Industries, Inc.*, 281 A2d 30, 35 (Del. Ch. 1971), the Court stated as follows:

> In short, I am of the opinion that the rights of plaintiffs and of other minority stockholders of Schenley, viewed in the light of Glen Alden's holding of approximately 84% of the common stock of Schenley, are no greater under the present Delaware merger statute here involved (8 Del.C. § 251) than under the so-called short-merger statute (8 Del.C. 253). Thus, if plaintiffs and others are not satisfied with the value placed on their shares by Glen Alden, and no *fraud or blatant overreaching* is demonstrated, their recourse is to an appraisal, Stauffer v. Standard Brand, supra.**

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* As the Court of Appeals stated below (124a):

> . . . the states have no power to preempt Congress in the creation of substantive rights and remedies arising from purchases and sales of securities in interstate commerce . . .

** As for the standard of "fraud or blatant overreaching", it is the one referred to in *Popkin* for Delaware law; thus, quoting *Greene* further (32):

> Glen Alden concedes that its control of the affairs of Schenley, including the naming of its directors and officers, is such as to call into play the rule applicable in all instances of corporate self-dealing, namely that when officers and directors stand on both sides of a transaction complained of "* * * they bear the burden of establishing its entire fairness, and it

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The mere fact that Santa Fe followed the form of a merger authorized by the state does not acquit it of the charge of fraudulent abuse. As the Supreme Court held in *Supt. of Insurance, supra,* in finding a violation of Rule 10b-5, "practices legitimate for some purpose may be turned to illegitimate and fraudulent means", 404 U.S., at 12. In the classic case of *Pepper* v. *Litton,* 308 U.S. 295, 306, this Court held:

> A director is a fiduciary . . . So is a dominant or controlling stockholder or group of stockholders . . . *Their powers are powers in trust.*

The Delaware short-form merger gave Santa Fe, with respect to Kirby and its minority stockholders, "a power in trust", not a license to abuse it and them. That the defendants followed meticulously the wording of the short-form merger provision is of course no evidence of lack of fraud. A long time ago the Supreme Court had occasion to point out that

> It is insisted that the proceedings were all conducted according to the forms of law. Very likely. Some of the most atrocious frauds are committed in that way. Indeed, the greater the fraud intended, the more particular the parties to it often are to proceed according to the strictest forms of law. *Graffam* v. *Burgess,* 117 U.S. 180, 186.

Thus in the leading case of *Lebold* v. *Inland Steel Co., supra,* the insiders were held liable for fiduciary fraud even

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> (the transaction) must pass the test of careful scrutiny by the courts".

In *Stauffer* v. *Standard Brands, Inc.,* 187 A2d 78 (Del.Sup. Ct. 1962), cited by the petitioners (PBr., *e.g.,* at p. 20), there was no showing of an intentional abuse of a fiduciary relationship; that is, a deliberate use of a short form merger for the substantial purpose of cheating the minority; moreover, prior notice of the merger was given to the stockholders; and the merger was warranted by legitimate business purposes.

though they had meticulously followed the letter of state-authorized dissolution proceedings; their purpose was eliminating minority stockholders without adequate compensation from the profits to be made from the continuation of a going concern. *Lebold* required the fiduciary to pay *more* than the value of the tangible assets; in our case the fiduciary has determined to pay even *less* than the fair value of the tangible assets.*

Petitioners say (PBr. 18) that under the Delaware procedure appraisal is the stockholders' exclusive remedy. While this assertion is not indubitable,** we believe that it is immaterial because the provision of any given remedy does not negate the fact that it is a fraud and particularly because what remedy is afforded by the state has no bearing on whether the transaction contravenes Rule 10b-5.

* The Court of Appeals stated (125 F2d, at 375):

> "Henry Ford could not rightfully say to one of the stockholders who invested in the Ford automobile company in its beginning and whose investment had multiplied thousands of times in value, that in view of the handsome returns he had upon the investment, he must deliver the stock to Mr. Ford upon receipt of his pro rata share of the value of the physical assets of the Ford Company or Mr. Ford would dissolve the company and bid in the assets and deprive him of any such returns."

** See *David J. Greene & Co., supra; Popkin* v. *Bishop,* 464 F2d 714, 720 (2nd Cir. 1972):

> Indeed, under the applicable Delaware law, the "entire fairness" of the merger would have to pass "the test of careful scrutiny by the courts" *Sterling* v. *Mayflower Hotel Corp.,* 33 Del. Ch. 293, 93 A2d 107, 110 (1952).

Bryan v. *Brock & Blevins Co.,* 490 F2d 563, 570-571 (5th Cir.) *cert. den.* 419 U.S. 844 (Georgia law) and *Peop.* v. *Concord Fabrics, Inc.,* 50 AD2d 787 (1st Dept.) aff'g on op. below, 83 M2d 120; *Berkowitz* v. *Power/Mate Corp.,* 137 N.J. Super. 36, 342 A2d 566 (Sup. Ct., Ch. Div. 1975) (unfair price); *Jutkowitz* v. *Bourns,* No. CA 000268 (Cal. Super. Ct., L.A. Co., 1975) (no sufficient corporate purpose), enjoined mergers under state law for fiduciary fraud. Of course, if the state does not provide equitable relief, that is all the more reason why the plenary relief to enforce Rule 10b-5 should be allowed.

The Supreme Court so held in *Supt. of Insurance, supra,* 404 U.S., at 12:

> Since there was a "sale" of a security and since fraud was used "in connection with it" there is redress under Section 10(b), whatever might be available as a remedy under state law.

The inadequacies in the appraisal remedy are set forth in the concurring opinion below of Mansfield, C.J. (148a-150a, fn. 4).*

Petitioners' suggestion (PBr. 19) that the operative terms in Section 10(b) and Rule 10b-5 can have only the meaning allowed by Delaware law is untenable. As this Court stated in *Ernst & Ernst, supra,* 425 U.S., at 206:

> The 1933 and 1934 Acts constitute interrelated components of the *federal regulatory scheme governing transactions in securities.*

There would be no "federal regulatory scheme" if Section 10(b) and Rule 10b-5 were fragmented into 50 state laws.**

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* Indeed, at least with respect to fiduciary fraud, Delaware's short form merger statute, with appraisal as the exclusive remedy, would appear to be so arbitrary as to deny due process. *North Georgia Finishing Inc.* v. *Di-Chem, Inc.,* 419 U.S. 601, and cases cited there. In declaring unconstitutional the statute in *Di-Chem* which provided for impounding a bank deposit *pendente lite,* the Supreme Court held that even a temporary deprivation of "use or possession" "is within the purview of the Due Process Clause" (at 606) and pointed to the fatal vice in the statute as follows (607):

> There is no provision for an early hearing at which the creditor would be required to demonstrate at least probable cause for the garnishment.

A like defect appears in the merger-appraisal statutory procedure, as construed by the defendants.

** See Circuit Judge Friendly, "In Praise of Erie—And Of The New Federal Common Law", *passim* and particularly p. 33: In the application of Rule 10b-5, the "interstitial supplementation is a matter of federal law"; and "the emphasis was on higher standards of conduct".

As a matter of national policy Congress has legislated against fraud in securities transactions and indeed has given the federal courts exclusive jurisdiction over the 1934 Act (15 U.S.C. § 78aa). The federal courts will therefore construe the terms of Section 10(b) and Rule 10b-5 in accordance with their plain meaning and history (*Ernst & Ernst, supra*), at 197 and 214, n.33 and in accordance with the congressional purpose. *Id.* at 194-5, 198, 206. Thus *SEC* v. *Nat'l Securities, Inc.,* 393 U.S. 453 (1969) held that even though a State had approved a merger of two corporations with appraisal rights as the remedy for the minority stock, "The paramount federal interest in protecting shareholders" (463) dictated that the federal court could set aside the merger under Rule 10b-5 (463-4). Petitioners cite *Erie R. Co.* v. *Tompkins,* 304 U.S. 64 (PBr. 20) but of course that case involved the law to be applied by a federal court under its diversity jurisdiction, not federal question jurisdiction. *Cort* v. *Ash,* 422 U.S. 66 (cited PBr. 20) disallowed a federal civil damage remedy under the statute there in question, but "the existence of a private cause of action for violations of the statute [§ 10(b)] and the Rule [10b-5] is now well established." *Ernst* v. *Ernst, supra,* at 196.*

Petitioners speak (PBr. 20) of "preemption of state corporate law" but nothing in the decision below suggests preemption of Delaware law. As Mansfield, C.J. stated in his concurring Opinion (152a) non-fraudulent short form mergers are not forbidden by Rule 10b-5. Section 10(b) and Rule 10b-5 are not concerned with short form mergers,

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* In *Cort, supra,* 422 U.S., 66, 85 the Court expressly pointed to the distinction between the case before it and the federal securities laws, stating:

> In *Borak,* the statute involved [Section 14(a) of the 1934 Act] was clearly an intrusion of federal law into the internal affairs of corporations; to the extent that state law differed or impeded suit, the congressional intent could be compromised in state-created causes of action.

long form mergers or any other corporate procedures—these are all matters of state law and remain so under the decision below. Rather, Section 10(b) and Rule 10b-5 embody "the federal interest at stake" in preventing "the kinds of fraud and manipulation in securities dealings to which a corporation [including its minority] is specially susceptible" by means of instruments of interstate commerce, regardless of the form under State law that the transaction takes.* As this Court stated in *United Housing Found., supra,* in noting the "primary purpose" of the 1933 and 1934 Acts "to eliminate serious abuses in a largely unregulated securities market" and the federally felt "need for regulation to prevent fraud and to protect the interest of investors"—

> Because securities transactions are economic in character Congress intended the application of these statutes to turn on the economic realities underlying "a transaction and not on the name appended thereto" (421 U.S., at 849).

Petitioners' suggestion (PBr. 20), that Delaware's interest in short form mergers by private corporations is comparable to its interest in the wages it may be required to pay its own employees in the discharge of its sovereign responsibilities, is so far-fetched as to be untenable on its face. The commerce power of Congress over securities fraud is beyond serious question and is not in issue in this case.

* Note, *supra*, 86 Harv. L. Rev., at 1046.

CONCLUSION

For the reasons set forth above, the judgment of the Court of Appeals with respect to petitioners should be affirmed.

Respectfully submitted,

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